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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

JEFF HATCH-MILLER, Chairman  
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MIKE GLEASON  
KRISTIN K. MAYES

2006 MAY 26 P 3:13

AZ CORP COMMISSION  
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IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE CURRENT FAIR  
VALUE OF ITS UTILITY PLANT AND  
PROPERTY AND FOR INCREASES IN ITS  
RATES AND CHARGES BASED THEREON  
FOR UTILITY SERVICE BY ITS PARADISE  
VALLEY DISTRICT

DOCKET NO. W-01303A-05-0405

IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY,  
INC., AN ARIZONA CORPORATION, FOR  
APPROVAL OF AN AGREEMENT WITH THE  
PARADISE VALLEY COUNTRY CLUB

DOCKET NO. W-01303A-05-0910

**ARIZONA-AMERICAN'S  
NOTICE OF FILING  
REPLY BRIEF**

1 Arizona-American Water Company hereby files its Reply Brief in the above-referenced  
2 matters.

3 **RESPECTFULLY SUBMITTED** on May 26, 2006.

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5   
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1 Original and 15 copies filed  
2 on May 26, 2006, with:

3  
4 Docket Control  
5 Arizona Corporation Commission  
6 1200 West Washington  
7 Phoenix, Arizona 85007  
8

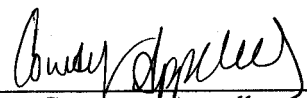
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**REPLY BRIEF OF ARIZONA-AMERICAN WATER COMPANY**

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1     **I.     INTRODUCTION**

2             Based on the parties' briefs, the same relatively few issues remain in this case. Only two  
3     issues are left between Arizona-American and Staff. Staff's proposed level of rate-case expense  
4     is inconsistent with levels the Commission has recently found to be reasonable in cases of similar  
5     complexity and duration. Also, Staff's return-on-equity calculation fails to compensate investors  
6     for financial risk and punishes Arizona-American for maintaining a rate-friendly capital  
7     structure.

8             RUCO's issues are more numerous. RUCO's rate-case expense allowance is based on a  
9     tiny case from several years ago that bears little resemblance to this case, which involves, among  
10    other things, multi-million-dollar investments for arsenic remediation and public safety.  
11    RUCO's ROE determination also fails to compensate investors for financial risk and punishes  
12    Arizona-American for maintaining a rate-friendly capital structure.

13            RUCO still strives to substitute its own judgment for that of the residents and elected  
14    representatives of the Town of Paradise Valley. To that end, RUCO opposes rate recovery in  
15    any manner for new infrastructure investment designed to protect the lives and property of Town  
16    residents.

17            Finally, RUCO still takes a number of positions that are contrary to Commission  
18    precedent, sound public policy, or both, such as its opposition to water-conservation rates. Some  
19    are just head-scratchers: why would any public agency oppose recovering the potentially life-  
20    saving expense of providing ice to employees who work in the hot Arizona sun?

21            Overall, the evidence supports a modest rate increase for the Paradise Valley Water  
22    District of 8.43%.

1    **II.    PUBLIC SAFETY INVESTMENTS**

2            **A.    GIFT CLAUSE**

3            RUCO remains opposed to Arizona-American recovering, in any manner, its investment  
4    in infrastructure designed to improve fire-flows in Paradise Valley and Scottsdale. The  
5    Company has already thoroughly discussed and will not repeat here why RUCO's opposition is  
6    against the wishes of the Town's residents, its elected representatives, and sound public policy.  
7    In this section, Arizona-American will respond only to RUCO's flawed argument that the Gift  
8    Clause of the Arizona Constitution (Article 9, § 7) would not bar the Town of Paradise Valley  
9    from funding the Company's fire-flow improvements.

10           RUCO believes that the Town should fund these improvements, even though the Town  
11    Attorney believes that the Gift Clause would bar such funding. Just as it believes that it knows  
12    better than the Town's residents and their elected officials, RUCO also believes that it knows  
13    better than the Town Attorney.

14           Because the Town doesn't believe that it can legally fund fire-flow projects, RUCO's  
15    argument is largely moot. Certainly, RUCO has not suggested any way that the Commission or  
16    any party could force the Town to actually fund the fire-flow projects. Given that there is an  
17    acceptable method to fund the projects—one that RUCO does not suggest is illegal and that is  
18    supported by the Town, Staff, and Arizona-American—there is little to be gained by responding  
19    at length to RUCO's interpretation of the Gift Clause. Nonetheless, Arizona-American will  
20    briefly discuss the case cited by RUCO and the Berneil Water interconnection.

21           RUCO claims that *Town of Gila Bend v. Walled Lake Door Co.*<sup>1</sup> would allow a  
22    municipality to contribute plant to an investor-owned water utility. It says no such thing. In that  
23    case, the Town of Gila Bend ("Gila Bend") contracted to build and own a water main to provide  
24    fire protection for a factory that had been destroyed by a fire. In return, Walled Lake Door

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<sup>1</sup> 107 Ariz 545, 490 P.2d 551 (1971).

1 Company, the factory's owner, agreed to rebuild the factory, which provided jobs for Gila Bend  
2 residents. After, Walled Lake Door rebuilt the factory and Gila Bend refused to carry out its  
3 contractual obligation, Walled Lake Door sued. The Court held, among other things, that the  
4 Gift Clause did not bar Gila Bend from performing its contractual obligation to build the main.

5 The facts in this docket are quite different. RUCO argues that the Gift Clause would not  
6 bar the Town of Paradise Valley from funding plant construction by Arizona-American—plant  
7 that Arizona-American would own and operate. In these circumstances, Paradise Valley would  
8 clearly be making a “donation or grant” to a corporation, which would be squarely barred by the  
9 Gift Clause. By contrast, Gila Bend retained ownership of and operating responsibility for the  
10 water main and booster pump, and no private water company benefited. No property or funds  
11 even changed hands. Therefore, the Gift Clause did not bar the Gila Bend from fulfilling its  
12 contractual obligations. The Gila Bend case does not support RUCO's position.

13 RUCO also suggests that the Town of Paradise Valley could fund Arizona-American's  
14 fire-flow improvements because the Town funded an interconnection to help Berneil Water  
15 Company provide adequate fire flows.<sup>2</sup> However, the Gift Clause only prohibits donations or  
16 grants to “any individual, association, or corporation,” not donations or grants to neighboring  
17 municipalities. The Town's agreement was with the City of Scottsdale.

18 Exhibit A-31 includes the Town Council minutes from May 12, 2005. At page 6, there is  
19 a discussion of the new interconnection, which clearly shows that the automated emergency  
20 interconnection would be built and owned by the City of Scottsdale.

21 Vice Mayor Winkler made a motion to enter into a letter agreement with the City  
22 of Scottsdale to install an automated emergency water connection from the City of  
23 Scottsdale water system to the Berneil water system for a cost of \$46,175.  
24 Councilmember LeMarr seconded the motion, which carried 7-0.

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<sup>2</sup> RUCO Brief, p. 8-9.

1 Funding went from the Town to the City of Scottsdale, which would retain ownership of the  
2 automated emergency connection. The Gift Clause does not apply. RUCO also does not suggest  
3 how this model—a letter agreement between the Town and the City of Scottsdale, with  
4 Scottsdale building and owning the facilities—could be applied to fund the Company's  
5 construction of fire-flow facilities within the Town or in Scottsdale.

6 **B. SCOTTSDALE CUSTOMERS – FIRE-FLOW COSTS AND BENEFITS**

7 Staff thoroughly explained how all Paradise Valley Water customers, including those in  
8 Scottsdale and the County, will benefit from fire-flow improvements.<sup>3</sup> Little more needs to be  
9 said, except to add that most Scottsdale customers will be exempt from the surcharges set to  
10 recover the costs of these benefits.

11 In Staff's initial proposal, only customers in the third block (consumption in excess of  
12 more than 80,000 gallons per month) would be subject to a fire-flow surcharge. Mr. Broderick  
13 prepared Exhibit A-33 to show the number of Scottsdale customers who would be likely affected  
14 by a high-block surcharge to fund fire-flow plant. Based on 2004 data, Exhibit A-33 reveals  
15 that, on average, about 3.6% of Scottsdale customers would fall into the high block, with at most  
16 6.5% consuming at high-block levels in June.

17 Under Staff's alternate proposal, a modest surcharge to fund fire-flow projects would also  
18 be applied to middle-block consumption (26,000 to 80,000 gallons per month). Exhibit A-33  
19 shows that, on average, only about 16% of Scottsdale customers would pay this surcharge. The  
20 worst case was January, where 28.3% of Scottsdale customers would pay this surcharge.

21 Put another way, the vast majority of Scottsdale customers will never pay any surcharge  
22 to fund fire-flow projects, even though all Scottsdale customers will enjoy the benefit of  
23 improved fire-fighting capability. On average, Exhibit A-33 shows that over 80% of Scottsdale  
24 customers will pay no surcharges.

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<sup>3</sup> Staff Brief, p. 7.



1    **III.    RUCO's RATE BASE ISSUES**

2        **A.    POST TEST-YEAR PLANT**

3        Arizona-American agrees with Staff that \$3,018,867 in post-test-year plant, designed to  
4        improve fire-flows in Paradise Valley, should be included in rate base.<sup>4</sup> RUCO is still totally  
5        opposed to recovery of fire-flow/public safety investment under any circumstances, including the  
6        \$3,018,867 investment in new public-safety infrastructure. This matter has already been  
7        extensively briefed by both the Company and Staff, and not much more needs to be said, except  
8        concerning an incorrect assertion in RUCO's brief.

9        In its brief, RUCO claims that "These discretionary expenditures, which concern fire  
10       flow improvements and total a minimum of \$16 million, will have the effect of doubling the  
11       Company's ratebase.<sup>5</sup> This is not true. Under Staff's proposal, accepted by the Company, only  
12       the initial \$3.019 million would be included in rate base. All remaining fire-flow investment  
13       would be funded by the high-block use surcharge. These funds will be treated as contributions,  
14       which directly offset rate base. Therefore, ratebase will not double, but will increase only by the  
15       initial \$3.019 million investment.

16       **B.    CASH WORKING CAPITAL**

17       Arizona-American reviewed Staff's working capital testimony,<sup>6</sup> and, in the interest of  
18       narrowing controversial issues, accepted Staff's proposed \$0 cash working-capital allowance.<sup>7</sup>  
19       RUCO continues to recommend a negative allowance. However, RUCO's lead-lag study that  
20       supports its recommendation suffered from a number of methodological deficiencies. Two  
21       examples follow.

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<sup>4</sup> Company Brief, p. 5.

<sup>5</sup> RUCO Brief, pp. 1-2.

<sup>6</sup> Dorf Direct, p. 6.

<sup>7</sup> Company Brief, p. 4.

1 RUCO included interest expense to bond-holders in its lead-lag study, which the  
2 Company was willing to accept.<sup>8</sup> However, Mr. Reiker pointed out, if these costs were reflected  
3 in a lead-lag study, then, to be consistent, the costs associated with compensating shareholders  
4 for their investments should also be included.<sup>9</sup> RUCO's lead-lag study did not reflect the  
5 additional lag between when shareholders were due compensation for their investments and  
6 when the funds were received, a 39.7-day wait.<sup>10</sup>

7 RUCO also arbitrarily increased the number of days from when the Company owed  
8 property taxes until it actually paid them.<sup>11</sup> Rather than use the actual payment date, RUCO used  
9 a hypothetical date – the last day the Company could make the payments without being  
10 delinquent.<sup>12</sup> This is arbitrary and unreasonable. As Mr. Reiker put it, "In the context of a  
11 lead/lag study, the date on which Arizona-American Water pays property taxes is no more  
12 inappropriate than the dates on which it pays its employees."<sup>13</sup>

13 **C. GAIN ON SALE OF LAND**

14 Arizona-American and Staff agree on the treatment of the gain associated with the sale of  
15 a parcel of land on Casa Blanca Road – customers should share 50% of the after-tax gain of  
16 \$481,680.84.<sup>14</sup> The customers should receive this refund over three years through a surcredit.<sup>15</sup>

17 RUCO would instead require the Company to pay the capital-gains taxes associated with  
18 the sale and then share the *pre-tax* gain with customers.<sup>16</sup> RUCO admits that its proposed

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<sup>8</sup> Reiker Rebuttal, pp. 16-17.

<sup>9</sup> *Id.*, p. 17.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* pp. 17-18.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*, pp. 7-8; Reiker Rejoinder, p. 5.

<sup>15</sup> *Id.*

<sup>16</sup> Coley Direct, pp. 7-8.

1 treatment is inconsistent with Commission precedent.<sup>17</sup> Arizona-American does not have  
2 anything further to add to its discussion in its brief about RUCO's position.

3 **D. PLANT HELD FOR FUTURE USE**

4 RUCO claims that both it and Staff recommend that certain plant held for future use be  
5 disallowed.<sup>18</sup> This is not correct. Staff and Arizona-American both recommend that two back-  
6 up submersible pumps, motors, and a transformer for the Company's Well No. 17 be included in  
7 rate base in the amount of \$132,682.<sup>19</sup> The Company does not have anything else to add to its  
8 discussion in its brief concerning this matter.

9 **IV. OPERATING INCOME**

10 **A. RATE CASE EXPENSE**

11 The parties agree on a three-year amortization but disagree on the amount of recoverable  
12 rate-case expense. Arizona-American recommends recovery of \$301,832 in rate case expense,<sup>20</sup>  
13 Staff would allow \$208,700 and RUCO just \$73,179. The Company thoroughly covered this  
14 issue in its brief so there are only a few points that remain to be made.

15 Staff and RUCO attack the Company's ROE testimony as if the Company were arguing  
16 that the Earth were flat. In fact, the testimony was presented by credentialed experts and is based  
17 on state-of-the-art financial theory, grounded in 50 years of economic research. And the point of  
18 the testimony is important. In determining ROE, the Commission has not been correctly  
19 compensating equity investors for risk. As a result Arizona-American's equity investors have  
20 not been adequately compensated for risk, but at the same time, equity investors in other Arizona  
21 utilities may have been overcompensated, through the allowed return on equity for the actual  
22 risks of their investments.

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<sup>17</sup> Coley Surrebuttal, p 5.

<sup>18</sup> RUCO Brief, p. 28.

<sup>19</sup> Reiker Rebuttal, pp. 6-7; Dorf Surrebuttal, p. 3.

<sup>20</sup> Broderick Rebuttal, p. 2; and Exhibit TMB-1.

1           This is an important issue for customers. What the data show is that investors in Arizona  
2 utilities are far better off if the utilities never issue debt. Even though debt is cheaper for  
3 customers, especially after considering the associated tax shield, the Commission penalizes  
4 companies for issuing debt, which results in higher customer rates.

5           Table D in the Company's brief clearly illustrated this truth.<sup>21</sup> Based on actual awarded  
6 returns in recent cases, the three water companies with the highest percentages of equity (73.4%  
7 for Arizona Water – Western; and 100% for Las Quintas Serenas and Rio Rico Utilities) had the  
8 three highest after-tax weighted costs of capital. Customers in each of these utilities were paying  
9 between 8.03 and 8.70% to compensate utility investors, while, at the low end of the equity scale  
10 (36.7%), Arizona-American's customers had the best deal. Even at the Company's requested  
11 ROE, its customers were only being asked to pay 6.48% to compensate investors.

12           Something is clearly not right with how the Commission sets overall returns. The  
13 Company will have more to say about this below. But this important message had to be  
14 delivered with maximum credibility, which required that acknowledged experts in the field of  
15 corporate finance be retained to prepare and deliver testimony. Ultimately, correcting the  
16 Commission's ROE methodology to properly account for risk will benefit all customers and  
17 investors. Customers should not have to pay for more risk than equity investors are actually  
18 incurring and, in turn, equity investors should be adequately compensated for the added risk of  
19 additional debt, particularly when customers are benefiting from low-cost, tax-shielded, debt.

20           As demonstrated in its brief, the remainder of the Company's rate-case expenses are  
21 completely consistent with those allowed in recent Commission decisions, especially given the  
22 significant, high-dollar issues in this case such as arsenic-remediation and fire-flow investments.

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<sup>21</sup> Company Brief, p. 25.

1           **B.     LABOR AND PENSION EXPENSES**

2           RUCO still proposes to disallow the expenses associated with an arsenic-plant operator,  
3 who was hired after the test year concluded.<sup>22</sup> The need for this employee was adequately  
4 demonstrated in the Company's brief.<sup>23</sup>

5           **C.     DEPRECIATION EXPENSE**

6           Arizona-American and Staff agree on total rate base and the corresponding depreciation  
7 expense. As discussed above, RUCO would reject rate-base treatment for approximately \$3  
8 million in fire-flow investment, along with the corresponding depreciation expense. The  
9 remaining depreciation difference is caused by RUCO's unorthodox gain-sharing method  
10 associated with the sale of the Casa Blanca Road parcel.<sup>24</sup> Both RUCO adjustments should be  
11 rejected, along with the associated depreciation-expense adjustments.

12           **D.     TAX EXPENSE**

13                 **1.     Property Taxes**

14           RUCO would reduce property-tax expense by \$44,561,<sup>25</sup> based on a methodology which  
15 the Commission has repeatedly rejected.<sup>26</sup> "RUCO's calculation methodology, which uses only  
16 historical revenues, unfairly and unreasonably understates property tax expenses and is therefore  
17 inappropriate for ratemaking purposes."<sup>27</sup>

18           RUCO would also offset property tax expense by \$56,844, based on its belief that  
19 Motorola should reimburse Arizona-American for property taxes associated with the Miller Road

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<sup>22</sup> RUCO Brief, p. 17.

<sup>23</sup> Company Brief, pp. 12-13.

<sup>24</sup> RUCO Brief, pp. 12-13.

<sup>25</sup> *Id.*, pp. 22-23.

<sup>26</sup> See Decision No. 68176, dated September 30, 2005 and Decision No. 68302, dated November 14, 2005. Copies of the relevant portions of these decisions were attached to Reiker Rebuttal as Rebuttal Exhibit JMR-RB-8.

<sup>27</sup> Decision No. 68302, p. 28.

1 Treatment Facility.<sup>28</sup> As discussed in the Company's brief, this is wrong for at least three  
2 reasons.<sup>29</sup> Nothing more needs to be added.

3 **2. Payroll Taxes**

4 RUCO proposes to reduce payroll-tax expense (\$4,295) associated with the new arsenic  
5 facility operator.<sup>30</sup> As discussed above, the labor expense for this employee should be recovered,  
6 along with the associated payroll-tax expense.

7 **E. ADMINISTRATIVE AND GENERAL EXPENSES**

8 RUCO proposes a total reduction in allocated A&G of \$53,372.<sup>31</sup> Arizona will discuss  
9 each in turn.

10 **1. Annual Incentive Program**

11 RUCO still proposes to disallow the majority (\$12,796) of the allocated AIP expense.<sup>32</sup>  
12 The Company has thoroughly explained why this disallowance would be wrongheaded.<sup>33</sup>  
13 Properly designed incentive compensation aligns employees with company goals, including  
14 those that directly benefit customers. And, if the AIP were discontinued, to be competitive in the  
15 market, Arizona-American would have to raise salaries by the amount of the discontinued AIP  
16 opportunities for each pay grade. Annual salary expense would remain the same, but the  
17 Company would lose a valuable means of aligning individual performance with corporate and  
18 customer goals. As Mr. Townsley said: "This makes no sense to me, nor should it to this  
19 Commission."<sup>34</sup>

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<sup>28</sup> RUCO Brief, p. 21.

<sup>29</sup> Company Brief, p. 14-15.

<sup>30</sup> RUCO Brief, p. 17, n. 17.

<sup>31</sup> *Id.*, pp. 17-20.

<sup>32</sup> *Id.*, pp. 18-19.

<sup>33</sup> Company Brief, pp. 15-16.

<sup>34</sup> *Id.*

1 RUCO does make one incredible statement: "Arizona American is a financially healthy  
2 Company ... ." <sup>35</sup> Therefore, RUCO concludes that comparing Arizona American's financial  
3 health to that of Arizona Public Service "is extreme and not equivalent." <sup>36</sup> However, RUCO's  
4 premise is wrong; the record in this case is replete with evidence of just how financially  
5 unhealthy Arizona-American's actually is.

- 6 • "Commission Staff simply has not taken appropriate notice and consideration of the  
7 Company's current poor financial condition." <sup>37</sup>
- 8 • "Arizona-American Water has not paid a dividend since 2003 and will not pay one in  
9 2006." <sup>38</sup>
- 10 • "We just suffered an impairment of \$23 million of the Company's capital structure  
11 under FAS 142 ... ." <sup>39</sup>
- 12 • "Arizona-American Water today has negative retained earnings. Arizona-American  
13 Water today has to seek capital infusions from outside of the utility in order to be able  
14 to continue to make investments in the state." <sup>40</sup>
- 15 • "[A]nd we need cash to enable us to continue to invest in our infrastructure in  
16 Paradise Valley and elsewhere." <sup>41</sup>

17 By contrast with other Arizona utilities that loudly claim financial hardship, Arizona-  
18 American has not paid out any multi-million-dollar bonuses, does not lease any boxes at any  
19 arenas, has not paid a dividend in the last three years, and has been unprofitable since 2002.

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<sup>35</sup> RUCO Brief, p. 18.

<sup>36</sup> *Id.*

<sup>37</sup> Broderick Rebuttal, p. 15.

<sup>38</sup> *Id.*

<sup>39</sup> Townsley Rebuttal, p. 8.

<sup>40</sup> 1 Tr 132.

<sup>41</sup> 1 Tr 140.

1 Further, on a stand-alone basis, Arizona-American likely would have long been rated in the junk-  
2 bond range. CoBank, Arizona-American's only outside lender, downgraded the Company in  
3 2004. "According to CoBank, the main driver in the deterioration in the creditworthiness of  
4 Arizona-American has been the inability of operating cash flow to keep pace with the amount of  
5 debt capital that has been required to meet capital requirements in the service territory."<sup>42</sup>  
6 Further, Arizona-American likely could not even borrow funds from the Arizona Water  
7 Infrastructure Finance Authority ("WIFA"), because "it does not appear that Arizona American  
8 would meet the interest coverage test in WIFA's requirements."<sup>43</sup> This is especially telling  
9 because WIFA loans funds to many of the smaller Arizona water utilities, yet Arizona's largest  
10 water utility cannot meet WIFA's lending standards.

11 Arizona-American is financially in critical condition, kept alive only by the willingness  
12 of its parent to continue to inject new equity and to loan funds at below-market rates in the hope  
13 of better days to come. This cannot go on forever. The Commission can take a few small steps  
14 to help Arizona-American back to health by:

- 15 • providing the rate relief requested in this case, including an ROE commensurate with  
16 equity investors' risk;
- 17 • approving Staff's alternate surcharge proposal so that the Company can recover  
18 existing investments and continue to invest in public-safety infrastructure; and
- 19 • approving the requested ACRM.

20 **2. Reorganizing/Downsizing Expenses**

21 Neither Staff nor the Company accept RUCO's proposed disallowance of what RUCO  
22 claims to be \$42,441 in so-called Employee relocation costs. RUCO has not provided any more  
23 persuasive reasons for this disallowance.

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<sup>42</sup> Stephenson Direct, p. 10.

<sup>43</sup> *Id.*, p. 17.



1                   3.     Ice

2             RUCO's most bizarre proposed disallowance has taken an even more bizarre turn. As  
3 discussed in its brief,<sup>44</sup> Arizona-American purchases ice and distributes it to its employees to  
4 keep water samples cool and to prevent field workers from becoming overheated in the hot  
5 Arizona sun. To justify a disallowance, RUCO now amazingly equates the provision of ice to  
6 providing liquor to employees: "The cost of food and perishables such as liquor, bottled water,  
7 ice, sodas and bagels should not be at the expense of ratepayers."<sup>45</sup> If Arizona-American were  
8 actually providing bagels and bourbon to its field crews, a disallowance for the associated  
9 expense would make sense. However, to use RUCO's words, "it is extreme and not equivalent"  
10 to equate providing employees life-saving ice with providing them bagels and bourbon.

11                   4.     Other

12             RUCO still would disallow another \$127 associated with Paradise Valley's share of costs  
13 associated with indoor plant maintenance and other items.<sup>46</sup>



14             Unlike Dilbert's company, Arizona-American's plants are real and do require watering. The  
15 expense is hardly extravagant and is recoverable for the reasons discussed in the Company's  
16 brief.<sup>47</sup>

<sup>44</sup> Company Brief, pp. 17-18.

<sup>45</sup> RUCO Brief, p. 20.

<sup>46</sup> *Id.*

1 **V. COST OF CAPITAL**

2 **A. CAPITAL STRUCTURE AND COST OF DEBT**

3 **1. Capital Structure**

4 The parties agree that Arizona-American's capital structure for the test year was  
5 comprised of 36.7% equity and 66.3% debt.

6 **2. Cost of Debt**

7 The parties agree that Arizona-American's cost of debt for the test year was 5.42%.

8 **B. RETURN ON EQUITY**

9 **1. Introduction**

10 The second-most important point to take away from the return-on-equity testimony is that  
11 the parties' ROE estimates for their sample companies do not differ that much. Based on his  
12 water-company sample, Dr. Vilbert applied standard ROE estimation methodologies to arrive at  
13 a range of ROE estimates from 7.2 to 10.8%. Applying the same methodologies to his gas-  
14 company sample, Dr. Vilbert calculated an ROE range of 7.7 to 9.6%. Staff's base estimate of  
15 10.0% and RUCO's base estimate of 9.5% fall squarely within Dr. Vilbert's overall range of 7.2  
16 to 10.8% for his two samples. This case is not about base ROE estimates.

17 The most important point to take away from the evidence is that *financial* risk matters to  
18 investors. This is not business risk, such as whether investors can earn on their investments.  
19 This is the risk associated with increased borrowing, also known as leverage. Leverage can  
20 increase returns to investors, but it also can magnify losses. The greater the leverage, the greater  
21 the financial risk. This case is about how to properly compensate equity investors as leverage  
22 increases.

23 One more collateral point. The parties do not disagree about the need to compensate  
24 equity investors for greater leverage. Staff states:

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<sup>47</sup> Company Brief, p. 18.

1 Because Arizona-American PV's capital structure is more highly leveraged that  
2 the sample water utilities capital structures, its stockholders bear additional  
3 financial risk. As a result its cost of equity is higher than that of water companies  
4 in Staff's sample<sup>48</sup>

5 RUCO agrees:

6 Publicly traded companies with a level of debt similar to the Company's would be  
7 perceived as riskier than the average of the sample and would therefore have a  
8 higher expected return on common equity.<sup>49</sup>

9 Because the parties agree on the need to provide equity investors with greater returns as leverage  
10 increases, the only remaining issue is how to correctly compensate equity investors for leverage  
11 increases.

12 The Commission has the opportunity—by setting the Company's allowed ROE at a level  
13 sufficient to compensate investors for the financial risk associated with higher leverage—to help  
14 begin restoring the Company's financial health. This is only fair; Arizona-American's customers  
15 have benefited for many years from the Company's ability to continue to borrow large amounts  
16 of subsidized, low-cost, tax-shielded debt. Arizona-American's equity investor (American  
17 Water) makes those borrowings possible by its willingness to assume the associated financial  
18 risk. Compensation should be commensurate with that risk.

19 **2. Reply to RUCO**

20 As just discussed, the major problem with RUCO's ROE analysis is not with Mr.  
21 Rigsby's initial ROE determination. Mr. Rigsby calculated an ROE for his sample of 9.5%,  
22 which is well within the range of ROEs calculated by Dr. Vilbert. The major problem with Mr.  
23 Rigsby's analysis is that he fails to adequately compensate Arizona-American's investors for the  
24 increased financial risk arising from the Company's greater leverage compared to his sample of  
25 other publicly traded water companies.

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<sup>48</sup> Staff Brief, pp. 15-16.

<sup>49</sup> RUCO Brief, p. 26.

1 To his credit, Mr. Rigsby recognized that some kind of additional return was needed to  
2 adjust for Arizona-American's increased leverage. His sample companies averaged 49.9%  
3 equity and 50.1% debt compared to Arizona-American's 37% equity and 63% debt. He  
4 therefore added 50 basis points to his base ROE calculation to arrive at his final recommendation  
5 of 10.0% ROE. "Mr. Rigsby simply considered the adjustment the Commission authorized in  
6 the Company's most recent rate case to arrive at his recommendation."<sup>50</sup>

7 In Decision No. 67093,<sup>51</sup> the Commission approved a capital structure for Arizona-  
8 American of 39.1% equity and 60.1% debt. In that case, all three parties, Staff, RUCO, and the  
9 Company, added 50 basis points "to account for the fact that Arizona-American is more  
10 leveraged than the sample water utilities included in the witnesses analysis."<sup>52</sup> Mr. Rigsby again  
11 used a 50-basis-point adder. But does an *ad hoc* 50-basis-point adder adequately compensate  
12 equity investors for the Company's highly leveraged capital structure?

13 The answer is "no." A 50-basis-point adder does not adequately compensate equity  
14 investors for Arizona-American's greater leverage, compared to Mr. Rigsby's sample. A simple  
15 example will confirm this answer.

16 If Arizona-American's leverage were exactly the same as Mr. Rigsby's sample  
17 company's, he would clearly (and correctly) not have recommended any leverage adjustment to  
18 his 9.5% ROE recommendation. In that case, the Company's after-tax cost of capital would be  
19 calculated as shown in Table 1:

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<sup>50</sup> *Id.*, p. 26.

<sup>51</sup> Decision No. 67093, Docket No. WS-013003A-02-0867, *et. al.*, dated June 30, 2004, p. 21.

<sup>52</sup> *Id.*, p. 22.

**Table 1 – RUCO: AAW’s ATWACC (assuming equal leverage as sample companies)**

	% Equity	Return	% LT Debt	Return	After-tax Return	After-tax WACC
AAW - Same Leverage	49.90%	9.50	50.10%	5.42	3.28	6.38%

The total return to Arizona-American’s debt and equity investors would be 6.38% and rates would be set based on this return.

In its brief, Arizona-American discussed at length the fundamental premise that overall weighted average returns to investors are constant over a wide range of equity ratios. As developed by two Nobel Prize winners, Modigliani and Miller, the basic premise is known as Modigliani and Miller’s Proposition II: *The expected rate of return on the common stock of a levered firm increases in proportion to the debt-equity ratio (D/E) expressed in market values ...*<sup>53</sup> Or, as put by Dr. Kolbe: *“There’s no magic in financial leverage.”*<sup>54</sup> Therefore, the cost of capital recovered from customers should be constant over a large range of equity ratios.

If RUCO’s leverage adjustment were correct, the after-tax weighted cost of capital to customers should not change as Arizona-American’s leverage changes. However, this is not the case as Table 2 shows:

**Table 2 – RUCO: AAW’s ATWACC (actual equity ratio of 36.7%)**

	% Equity	Return	% LT Debt	Return	After-tax Return	After-tax WACC
AAW - Actual leverage	36.70%	10.00	63.30%	5.42	3.28	5.75%

Table 2 demonstrates that RUCO’s 50-basis-point adjustment (from 9.5 to 10.0%) was inadequate, because the after-tax weighted cost of capital plummeted from 6.38% to 5.75%, even though the debt cost did not change. Therefore, equity investors are now inadequately compensated for the increased risk of the more highly leveraged capital structure. Looking at it from the customers’ point of view; they are benefiting from the Company’s higher percentage of

<sup>53</sup> Brealey and Myers, *Principles of Corporate Finance* (6<sup>th</sup> Ed.), p. 481.

<sup>54</sup> Kolbe Direct, p. 33.

1 low-cost, tax-shielded debt, but they are not compensating the Company's equity investors for  
2 their greater financial risk. This is fundamentally unfair.

3 As discussed at length in Arizona-American's brief, the Commission's historic failure to  
4 properly compensate equity investors for increased leverage has been compounded by its  
5 overcompensation of equity investors in companies with equity ratios higher than industry  
6 averages. Consequently, rates for customers of these companies have been set too high, because  
7 the Commission has set the weighted average cost of capital too high.

8 *Ad hoc* adjustments, like the 50-basis-point adder used by Mr. Rigsby, cannot correctly  
9 adjust returns on equity, so that customers are indifferent toward their utility's capital structure.  
10 Unless ROEs are correctly adjusted, companies will resist issuing low-cost, tax-shielded debt,  
11 even if customers' rates would be reduced as a result. In other words, Staff's and RUCO's  
12 methodologies actually promote higher rates. Only Equitable Leverage Compensation can adjust  
13 equity returns in a simple-to-apply, theoretically-sound manner.

14 **3. Reply to Staff**

15 The same points made concerning RUCO's ROE testimony also apply to Staff's ROE  
16 testimony. The average capital structure for Staff's sample water utilities was "comprised of  
17 approximately 50.9% debt and 49.1% equity."<sup>55</sup> Staff calculated the ROE for its sample utilities  
18 to be 9.8%.<sup>56</sup> Based on a method developed by Professor Robert Hamada, Staff then added 60  
19 basis points to its sample company ROE estimate to derive its overall ROE recommendation of  
20 10.4%.<sup>57</sup>

21 Again, Staff deserves credit for recognizing that equity investors require additional  
22 compensation as leverage increases. However, the Hamada leverage adjustment method is

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<sup>55</sup> Staff Brief, p. 14.

<sup>56</sup> *Id.*, p. 15.

<sup>57</sup> *Id.*, p. 16.

almost 40 years old.<sup>58</sup> It well predates “the wealth of research the underlies the finding that ATWACC is essentially flat across a broad range of capital structures.”<sup>59</sup> By contrast, Equitable Leverage Compensation applies this fundamental proposition to properly determine ROEs, regardless of the leverage.

Another simple example demonstrates that Staff’s application of the Hamada method results in after-tax weighted costs of capital that vary with equity ratios. Again, we will assume that AAW’s leverage was the same as the sample companies, which would have resulted in a 9.8% ROE recommendation with no leverage adjustment.

**Table 3 – Staff: AAW’s ATWACC (assuming equal leverage as sample companies)**

Staff	% Equity	Return	% LT Debt	Return	After-tax Return	After-tax WACC
<b>AAW - Same Leverage</b>	49.10%	9.80	50.90%	5.42	3.28	6.48%

The resulting ATWACC would be 6.48%. *This is exactly the same ATWACC requested by the Company.*

Again, we will now use the Company’s actual equity ratio of 36.7% along with Staff’s 60-basis-point adjustment to demonstrate how ATWACC drops significantly.

**Table 4 – Staff: AAW’s ATWACC (actual equity ratio of 36.7%)**

Staff	% Equity	Return	% LT Debt	Return	After-tax Return	After-tax WACC
<b>AAW - Actual Leverage</b>	36.70%	10.40	63.30%	5.42	3.28	5.89%

Even with the Staff’s 60-basis-point upward ROE adjustment, ATWACC has dropped by almost 60 basis points. By contrast, the Equitable Leverage Compensation method keeps ATWACC constant, which properly compensates investors and leaves customers indifferent to the Company’s actual capital structure.

<sup>58</sup> The Hamada method was developed in a 1969 paper. See, Kolbe Rebuttal, p. 23, n. 8.

<sup>59</sup> Kolbe Rebuttal, p 23.

A 5.89% ATWACC would be significantly lower than any awarded by the Commission in the last two years, despite rising interest rates over the time period. For convenience, Arizona-American reprints the summary table from its brief.

**Table 5 – Recent ACC Overall Cost of Capital Awards**

Utility	Decision	Year	% Equity	% P'fd Equity Return	% ST Debt Return	After-tax Return	% LT Debt	After-tax Return	After-tax Return	After-tax WACC
AAW RUCO		2006	36.70%	10.00		0.00	63.30%	5.42	3.28	5.75%
AAW Staff		2006	36.70%	10.40		0.00	63.30%	5.42	3.28	5.89%
AAW Requested		2005	36.70%	12.00		0.00	63.30%	5.42	3.28	6.48%
Southwest Gas	68487	2005	40.00%	9.50	5.00% 8.20	0.00	55.00%	7.61	4.60	6.74%
Pineview Water	67989	2005	51.00%	8.90		0.00	49.00%	5.43	3.29	6.15%
APS	67744	2005	55.00%	10.25		0.00	45.00%	5.80	3.51	7.22%
Chapparral City	68176	2005	58.73%	9.30		0.00	41.27%	5.10	3.09	6.74%
AZ Water Eastern	66849	2004	66.20%	9.20	5.60% 4.00	2.42	28.00%	8.46	5.12	7.66%
AZ Water Western	68302	2005	73.40%	9.10		0.00	26.60%	8.40	5.08	8.03%
Las Quintas Serenas	67455	2005	100.00%	8.10		0.00	0.00%	0.00	0.00	8.10%
Rio Rico Utilities	67279	2004	100.00%	8.70		0.00	0.00%	0.00	0.00	8.70%

If the Commission were properly adjusting for leverage, ATWACCs should be relatively constant, after taking into account differences in embedded debt costs and variations in ROE caused by general economic factors. Instead, the trend is clear; the greater the leverage, the lower the ATWACC.

If the Equitable Leverage Compensation method is so logical, simple to apply, and yields fair results, why is Staff so opposed to it? Staff does not and could not challenge the basic financial theory and supporting research that underpins the method. Nobel Prizes have been awarded for the insights that support it. Instead, Staff's fundamental opposition is that the method is new and has not yet been accepted in every regulatory jurisdiction.

Let's look first at where the Equitable Leverage Compensation method has been accepted. In the last 15 years, government-owned utilities have been privatized in countries such as Australia, New Zealand, and Great Britain.<sup>60</sup> Regulators in these countries were able to study regulatory regimes throughout the world, including U.S. state and federal rate regulatory bodies. They were able to evaluate what worked best in the other regimes and update their rate-setting

<sup>60</sup> *Id.*, p. 29.



1 methodologies to incorporate the latest in financial research.<sup>61</sup> Regulators in these countries now  
2 set rates based on methodologies consistent with that advocated by Drs. Kolbe and Vilbert.

3 In the U.S., the federal government's newest rate regulation body, the Surface  
4 Transportation Board was established in 1995.<sup>62</sup> It was also able to take advantage of the latest  
5 financial research. It also uses market value weights to determine the required rates of return for  
6 interstate railroads,<sup>63</sup> as recognized by the most widely used financial textbook in U.S.  
7 universities: Brealey and Myers, *Principles of Corporate Finance*.<sup>64</sup> Although Arizona-  
8 American cannot verify it, the Brealey and Myers textbook is purportedly used in every one of  
9 the top 20 U.S. MBA programs. It has also been cited as authority dozens of times in Staff's  
10 own cost-of-capital testimony. Co-author Stewart Myers is also a Brattle Group principal, along  
11 with Drs. Kolbe and Vilbert.<sup>65</sup>

12 Brealey and Myers do apply modern financial theory to an example of how to properly  
13 calculate costs of capital for a regulated industry.<sup>66</sup> The example they use is based on the method  
14 used by the Surface Transportation Board. The authors first calculate the aggregate industry  
15 capital structure (in 1997) as follows:

	Market Value (Billions)	Financing Weights
Debt	\$24,382.50	29.7%
Equity	\$57,650.50	70.3%

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<sup>61</sup> *Id.* pp. 29-30.

<sup>62</sup> <http://www.stb.dot.gov/stb/about/overview.html>.

<sup>63</sup> *Id.*, p. 30.

<sup>64</sup> Now in its 8<sup>th</sup> edition, 2006.

<sup>65</sup> <http://www.brattle.com/Consultants/ConsultantView.asp?ConsultantID=65>.

<sup>66</sup> Brealey and Myers, *Principles of Corporate Finance* (6<sup>th</sup> Ed.), p. 549.

1 The average cost of debt was 7.2%. Then, Brealey and Myers used the constant growth DCF  
2 model to calculate a cost of equity of 13.8%. Based on the statutory marginal tax rate of 35%,  
3 the railroad industry ATWACC in 1997 was:

$$4 \quad \text{ATWACC} = 0.072(1 - .35)(.297) + .138(.703) = 11.1\%$$

5 Arizona-American concedes that so far only one state regulatory body has adopted the  
6 Equitable Deleveraging Compensation method, the Missouri Public Service Commission.  
7 However, that should not deter this Commission from being the second state commission to  
8 properly apply modern financial methods to properly calculate the effects of leverage on required  
9 ROEs. Clearly, there is a problem with the way the Commission is presently adjusting (if at all)  
10 ROEs for leverage differences. As Table 5 demonstrates, customers are overpaying equity  
11 investors in companies with little leverage and underpaying equity investors in companies with  
12 more leverage than the industry average. Thus, the Commission has been setting customer rates  
13 to discourage companies from borrowing at low tax-shielded interest rates and passing the  
14 savings on to customers.

15 Companies like Arizona-American that are more leveraged than average face a difficult  
16 challenge in Arizona. The Commission has been encouraging the Company to increase its equity  
17 ratio, a goal the Company shares. On the other hand, the Commission has not been setting equity  
18 returns high enough to attract the needed equity by fairly compensating investors for the greater  
19 risk associated with greater leverage. This sets up a situation where more borrowing may be the  
20 Company's only option to finance needed infrastructure, but, unfortunately, the cost of  
21 borrowing also increases along with greater leverage. In the worst case, if equity returns do not  
22 properly compensate for leverage risk, regulators could send a company into a death spiral where  
23 all equity is ultimately wiped out by the bankruptcy court, not a desirable outcome for the  
24 customers, the regulators, or the company.

1 Staff alleges that there are “several serious flaws” with Drs. Kolbe’s and Vilbert’s  
2 approach,<sup>67</sup> but merely repeats several allegations from Mr. Rogers’ direct testimony that Dr.  
3 Kolbe thoroughly rebutted in his rebuttal testimony. Staff first alleges that “using a market value  
4 capital structure to estimate the cost of equity is predicated on the underlying erroneous logic  
5 that the Commission is obligated to maintain stock prices and perpetuate an ongoing rising spiral  
6 between revenues and stock prices.”<sup>68</sup> However, Mr. Rogers’ allegation is based on the  
7 erroneous assumption that market values are affected by capital structure.

8 Dr. Kolbe states:

9 The market automatically corrects the cost of equity for the change in capital  
10 structure, and no “perpetual upward cycle” due to an “ongoing rising spiral  
11 between revenues and stock prices” results. Instead, the regulated firm’s revenues  
12 are based on the ATWACC and so are independent of the sample’s precise capital  
13 structure. This is what a flat ATWACC means.<sup>69</sup>

14 Brealey and Myers call this the “*law of conservation of value*. The value of an asset is  
15 preserved regardless of the nature of the claims against it. ... Firm Value is determined on the  
16 left-hand side of the balance sheet by real assets—not by the proportion of debt and equity  
17 securities issued by the firm.”<sup>70</sup>

18 Staff also maintains that its method of calculating the ROE for its sample group of  
19 companies is superior to the methods used by Dr. Vilbert.<sup>71</sup> Although the Company does not  
20 concede this point and could argue its merits, the argument is moot. As discussed above, Staff’s  
21 calculated ROE is well within the range of the ROEs calculated by Dr. Vilbert. Further, if

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<sup>67</sup> Staff Brief, p. 17.

<sup>68</sup> *Id.*, quoting Rogers Direct at 37.

<sup>69</sup> Kolbe Rebuttal, p. 20.

<sup>70</sup> Brealey and Myers, p. 477.

<sup>71</sup> Staff Brief, pp. 17-18.

1 Staff's calculated ROE is properly corrected for leverage, the Company has shown that Staff's  
2 recommended ATWACC would be identical to that requested by the Company – 6.48%.<sup>72</sup>

3 Staff also claims that under Dr. Kolbe's methodology the cost of equity is dependent  
4 upon the cost of debt.<sup>73</sup> This balloon has already been popped repeatedly. As discussed at  
5 length, the cost of equity is independent of the cost of debt. It is the proportion of debt in the  
6 capital structure (leverage) that affects the cost of equity, a proposition that Staff has no quarrel  
7 with.

8 Because Arizona-American PV's capital structure is more highly leveraged than  
9 the sample water utilities capital structures, its stockholders bear additional  
10 financial risk. As a result its cost of equity is higher than that of water companies  
11 in Staff's sample."<sup>74</sup>

12 Staff further claims (without citation) that Kolbe and Vilbert erroneously use historical  
13 debt costs that do not reflect current costs.<sup>75</sup> Counsel was unable to locate where Mr. Rogers  
14 made this claim, but it appears to be incorrect if it were made. Further, this point is also moot,  
15 since Staff's and the Company's ROE estimates are largely consistent. Again, the issue is with  
16 Staff's inadequate adjustment for Arizona-American's greater leverage.

17 Finally, Staff prepared a chart taken from Exhibit S-12 to show that its recommended  
18 10.4% ROE was within the range of equity returns awarded to Arizona-American affiliates by  
19 other state regulators.<sup>76</sup> However, this chart is of little value, because it fails to account for  
20 differences in the affiliates' capital structures.

21 Q. Dr Kolbe, did you look at, review an exhibit – I believe it was S-12, is that  
22 right? Did that contain a list of returns on equity that were requested and  
23 authorized in various jurisdictions?

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<sup>72</sup> See Table 3, above.

<sup>73</sup> Staff Brief, p. 18.

<sup>74</sup> *Id.*, pp. 15-16.

<sup>75</sup> *Id.*, p. 18.

<sup>76</sup> *Id.*, pp. 16-17.

1 A. I held it in my hand and looked at it. I didn't study it.

2 Q. For that to be complete, is there any other information that you would want to  
3 see in that kind of document?

4 A. Sure, capital structure.

5 Q. Why would that be?

6 A. For the reasons Dr. Vilbert discussed. A cost of equity value is not, is not  
7 meaningful by itself because it might involve the same level of business risk  
8 but widely varying [levels] of management [risk].<sup>77</sup>

9 To properly account for capital-structure variances, the Company prepared Exhibit A-33,  
10 which displays the after-tax weighted average costs of capital awarded by regulators to Arizona-  
11 American affiliates in 2004 and 2005. Page one of Exhibit A-33 shows that equity thicknesses  
12 (ratios) for affiliates with rate orders ranged from 0.37 to 0.59. Allowed returns varied from 9.85  
13 to 10.1%. After weighting the cost components, the ATWACCs awarded in 2005 averaged  
14 6.19%. For Arizona-American to equal the average ATWACC awarded to its affiliates in 2005,  
15 the last line of page one shows that its ROE would have to have been set at 11.01%, 61 basis  
16 higher than the Staff is recommending in 2006, after numerous interest-rate increases by the  
17 Federal Reserve Board.

18 Similarly, on page two, the average ATWACCs for 2004 was 6.55%. Again, on the last  
19 line, the required ROE for Arizona-American to equal the average ATWACC would be 12.0%.

20 Again, what Exhibit A-33 shows is that Staff's recommended 10.4% ROE is well below  
21 what Arizona-American would need to be compensated at the same average level that other  
22 regulatory commissions have provided its affiliates. The Company's requested 12.0% ROE,  
23 when applied to its highly leveraged capital structure will fairly compensate equity investors,  
24 while still (as shown on Table 5) providing its customers one of the lowest ATWACCs in  
25 Arizona.

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<sup>77</sup> 2 Tr. 246-47.

1 Finally, a 12% cost of equity and a 5.42% cost of debt are already too low to fully  
2 compensate investors over most of the period in which rates will be in effect in this case. Given  
3 the given recent interest rate rises, it is reasonable to assume that if the parties were to today  
4 recalculate proxy ROEs, the results would be higher than calculated a year ago. Further, much  
5 of Arizona-American's low-cost debt is maturing in November 2006, so the Company recently  
6 has had to apply to refinance that debt.<sup>78</sup> Given recent interest-rate trends, the refinanced debt  
7 will also carry a higher interest rate. Therefore, the embedded cost of debt used to set rates in  
8 this case will be too low to compensate the Company for its actual cost to carry debt during most  
9 of the period in which rates will be in effect in this case.

10 **VI. RATE INCREASE**

11 Based on the Company's proposed adjustments, Paradise Valley's adjusted test year  
12 operating income is \$866,762, and its adjusted test year original cost rate base ("OCRB") is  
13 \$14,412,903. Multiplying the Company's proposed 7.84 percent rate of return by the OCRB  
14 produces required operating income of \$1,129,527. This is \$262,765 more than the Company's  
15 test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion  
16 factor of 1.6286 results in an increase in revenues of \$427,939, or an 8.43 percent net increase  
17 over test year adjusted revenues.

18 **VII. RATE DESIGN**

19 **A. GENERAL RATE DESIGN**

20 Staff and Arizona-American agree on the appropriate general rate design. RUCO  
21 recommends no changes to existing rate design.<sup>79</sup> The Company has already addressed this issue  
22 in its brief.

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<sup>78</sup> Docket No. WS-01303A-06-0283.

<sup>79</sup> RUCO Brief, p. 28.

1           **B.     HIGH BLOCK USAGE SURCHARGE**

2           For the reasons given in its brief, Arizona-American recommends that the Commission  
3 approve Staff's alternate surcharge proposal, as described by Mr. Carlson in Exhibit S-9.

4           **VIII.   ACRM APPROVAL**

5           All parties agree that Arizona-American's ACRM proposal should be adopted.<sup>80</sup>

6           **IX.     SPECIAL CONTRACT – PARADISE VALLEY COUNTRY CLUB**

7           Staff agrees that this contract should be approved.<sup>81</sup> In its brief, Arizona-American stated  
8 that RUCO also supported the contract. Actually, RUCO did not take a position on this issue.

9           **X.      CONCLUSION**

10          RUCO has taken a number of extreme positions that are contrary to Commission  
11 precedent, sound public policy, or both. The Commission should reject each of RUCO's  
12 proposed adjustments.

13          Staff disagrees with Arizona-American only concerning the appropriate level of rate-case  
14 expense and the return needed to compensate equity investors for their financial risk. The  
15 Company's requested level of rate-case expense is appropriate, given recent Commission rate-  
16 expense awards and the significant large-dollar issues in this case.

17          The parties' base ROE estimates do not materially differ. However, Staff and RUCO fail  
18 to adequately adjust their base ROE estimates to compensate equity investors for Arizona-  
19 American's greater leverage. This compensation is equitable because this greater leverage  
20 means that the Company carries large amounts of subsidized, low-cost, tax-shielded debt. As a  
21 result, even at the Company's requested ROE, its overall cost of capital will still be among the  
22 lowest in Arizona, and well below the overall returns for Arizona' largest investor-owned  
23 electric and gas utilities.

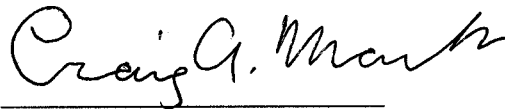
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<sup>80</sup> Chelus Direct; Igwe Direct, pp. 19-24; Moore Direct, pp. 32-34.

<sup>81</sup> Carlson Surrebuttal, p. 8.

1           Therefore, Arizona-American has demonstrated that it requires a revenue increase of  
2 \$427,939, or an 8.43 percent net increase over test-year adjusted revenues.

3           RESPECTFULLY SUBMITTED on May 26, 2006.  
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